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ENERGY AND THE CANADA-U.S. FREE TRADE AGREEMENT

by

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Reactions to the energy chapter of the Canada-U.S. Free Trade Agreement have ranged from enthusiastic endorsement to confusion and concern. Both Canada and the United States had good reason for wanting to clarify their bilateral energy trade relationship in the free trade negotiations. Most people still clearly remember the energy shocks of the 1970s and the often-divisive policy responses by governments. In Canada's case, the balance between energy supply and demand has been favorable for several years, and Canadian producers of natural gas, electricity, and uranium have been focusing on expanding their sales into the U.S. market. Projections indicate, however, that Canada likely will become a significant net oil importer in the 1990s, especially if oil prices remain at recent levels. Americans, for their part, are becoming concerned about their increasing reliance on oil from the volatile Middle East. Although U.S. energy prices are relatively low and supplies more than adequate, pressures are growing in the United States to invoke an oil-import tariff or some other protective device to curb that country's reliance on foreign sources of energy.

On both sides of the border, therefore, reactions to the energy chapter have focused on what the Agreement means for security of energy supplies and market access, and for the ability of each country to establish its own energy policy. While the Agreement raises many interesting and important questions with respect to energy policy, the debate in Canada has been considerably confused. For example, some prominent opponents of the Agreement have made the following claims:

- "U.S.-controlled companies will drain Canada's reserves to supply the United States."
- "Ottawa has surrendered its capacity to regulate exports of energy to the advantage of the Canadian national interest and consumers."

• "The free trade agreement results in a continental energy policy which would force Canada to share energy shortages with the United States and would prevent it from using its energy resources for industrial advantage or to protect consumers from future price shocks."

When it was unveiled on October 3, 1987, the energy chapter seemed to surprise both opponents and advocates of free trade. Their first impression was that Canada had made a major concession that went well beyond its commitments in other areas of the Agreement. Energy Minister Marcel Masse and Chief Trade Negotiator Simon Reisman both issued statements arguing that Canada would benefit from the energy component of the Agreement and that the dire predictions were wrong. But it was not until the final legal text of the Agreement was made available on December 10, 1987, that it was possible to refute fears that U.S. interests, rather than Canadian government policies, would determine the future development and use of Canadian energy.

The Agreement <u>does not</u> mean:

• that Canada loses control over the development and use of its energy -- federal and provincial governments and their agencies, such as the National Energy Board (NEB) and the Alberta Energy Resources Conservation Board, retain their ability to regulate exploration, production, exports, and prices;
• that U.S.-owned companies can buy up Canadian energy reserves -- Canada retains its policy preventing takeovers of financially healthy Canadian energy companies;
• that Canada is prevented from cushioning the impact on consumers of a future sharp increase in energy prices -- Canada can maintain oil prices below world levels, although this would have to apply also to exports to the United States; alternatively, Canada can use personal transfers, such as an energy tax credit, to ease the impact on Canadian consumers only; or
• that Canada will be unable to use its energy resources for industrial advantage -- Canada will continue to benefit industrially from its abundant and secure supplies of energy.

What the Agreement <u>does</u> is:

• prohibit government intervention to set prices that discriminate against U.S. purchasers;
• prohibit export taxes;
• prohibit most restrictions on energy exports and imports except where these are permitted under the General Agreement on Tariffs and Trade (GATT) due to short supply, conservation, or national security; and
• establish rights of consultation in cases where regulatory actions distort trade.

Perhaps the most important thing to understand about the energy chapter is that it represents nothing more than an extension and clarification of Canada's existing rights and obligations on energy trade under the GATT. The proportional-sharing commitment to which many critics object is not new, but merely a reaffirmation of what Canada and the United States already have agreed to as GATT members. Thus, those who criticize the Agreement on the grounds that Canada could have obtained a better deal through multilateral negotiations are entirely wrong with respect to the energy chapter. Indeed, the rhetorical comments of most critics of the energy chapter suggest that they would oppose Canada's living up to its existing GATT commitments on trade in energy.

This <u>Trade Monitor</u> assesses the energy chapter from a Canadian perspective. A major part of the debate on energy has focused on the degree to which Canadian governments will be able to intervene to pursue "independent" energy policies in the future. Indeed, Canadians' reactions to the energy chapter are likely to depend heavily on their views about the appropriateness and effectiveness of both

the Canadian and U.S. governments' past interventions in energy policy.

In order to provide a clearer understanding of the policy options that the two countries have given up, the next section is devoted to an historical review and assessment of the energy policies they have followed since the 1950s. The key conclusion is that, through much of this period, both countries have ignored GATT rules, and in so doing, have imposed large efficiency costs on their respective economies.

Readers who are familiar with past Canadian and U.S. energy policies may wish to skip to the third section, which describes and interprets what the Agreement contains on energy, and which points out the main benefits for Canada's energy industries. The analysis concludes with some observations about Canada's ability to set an independent energy policy under free trade.

Canadian and U.S. Energy Policies in Retrospect

From the end of World War II until the early 1980s, energy policy in the United States and Canada was marked by heavy government intervention to influence the price of energy -- particularly oil. The two countries' policies on oil, natural gas, electricity, and uranium were highly interdependent, with Canada normally setting its approach to energy contingent on U.S. policies. Canada has, of course, made independent decisions on which approach to energy policy was most appropriate. But in dealing with changing conditions in the international energy market, Canada's most effective approach has been to take account of U.S. energy policies.

In 1981, the United States decided to allow energy prices to be set, where feasible, by market forces. Canada followed suit in 1985. These decisions represented a profound shift in the energy policies of the two countries. In a summary of energy policy followed by U.S. administrations from Truman to Carter, a Brookings Institution study states:

> The story of energy policy in the United States is largely an account of the failure of genuinely free markets to appear and of the unwillingness of most market participants -- buyers, sellers, and government -- to allow a free market structure to develop. Despite much rhetoric from all parties on behalf of free enterprise, far more effort was devoted to destroying market freedom if it began to emerge than to perfecting it. For quite different reasons these generalizations hold for all major energy sources.[1]

This generalization is equally valid for Canada. For most of the postwar period, Canadian government policies have heavily influenced energy prices in ways that have distorted market signals.

One can identify three distinct stages of North American energy policy:

- the period from the mid-1950s to 1973, when world oil prices were falling and U.S. and Canadian policies were directed toward artificially raising prices by restricting imports;
- the period from 1973 to the early 1980s, when world oil prices were rising and U.S. and Canadian policies were directed toward artificially lowering prices by direct price regulation and restrictions on exports; and
- the period since the early 1980s, when both countries, by deregulating prices and eliminating most restrictions on imports and exports, have allowed domestic oil prices to be determined by market forces.

Stage 1: Supporting Domestic Oil Prices, 1955-73

U.S. Oil Import Quotas

During the 1950s, world oil production increased dramatically as multinational oil companies developed new sources of supply in the Middle East and Africa. These additional supplies of low-cost oil put downward pressure on international crude oil prices. As oil imports to the United States grew, reaching about 9 percent of U.S. oil demand in 1954, U.S. domestic producers began to voice concerns that lower-cost foreign oil was threatening their position in the U.S. market.

In 1955, in response to these concerns, the United States introduced a Voluntary Oil Import Policy aimed at freezing oil imports. It cited national security -- to support the development of U.S. oil reserves to ensure U.S. preparedness in the event of war -- as the justification for this policy. The voluntary program failed to stem the increase in oil imports, so in 1959 a Mandatory Oil Import Quota was introduced. This time, the justification was that imports had to be limited to maintain domestic production needed for national defense requirements and the capacity of the United States to meet national security requirements. Canadian oil, because it could be supplied to the United States by land through pipelines, was not considered a security risk and, therefore, was exempted from the mandatory quota system.

Since the mandatory quota limited imports, remaining demand had to be met by domestic production from many low-volume, high-cost wells. U.S. oil prices had to rise to encourage the necessary supply, and U.S. oil prices were held above those elsewhere in the world throughout most of the 1950s and 1960s.[2]

Canada's National Oil Policy

After the United States imposed its Mandatory Oil Import Quota, the Canadian government was in a position to choose whether Canada should take advantage of cheap, abundant supplies of oil in world markets or follow the U.S. lead and protect the Canadian petroleum industry.

The Canadian industry had expanded rapidly in the early 1950s, but by 1958, after the Suez crisis had passed, Alberta's oil industry was operating at just 40 percent of capacity. In 1959, the Borden Royal Commission on Energy recommended that, to aid the Western Canadian oil industry, the government should take steps to displace some imported crude oil and products. Eighteen months later, the federal government introduced the National Oil Policy, which restricted imports of crude oil and petroleum products to the region east of the Ottawa valley.

Although Canada had received an exemption from the U.S. oil import quota, it was still under U.S. pressure to restrain exports. Nevertheless, Canadian oil exports to the United States rose to 279,000 barrels per day in 1964 from 113,000 barrels per day in 1960.

Given a choice, Canada decided to follow the U.S. lead in protecting its domestic oil industry. Both countries, in fact, were breaking the spirit, if not the letter, of their commitments under the GATT. The United States relied on a broad interpretation of national security as the justification for its quotas, while Canada circumvented GATT rules by operating a policy of "voluntary" restraints on imports through moral suasion and cooperation with the large oil companies.

While the protection greatly assisted U.S. and Canadian oil-producing firms and regions, it carried a substantial price tag. A U.S. Cabinet Task Force estimated that, in 1969, U.S. consumers paid U.S.$5 billion more for oil products than they would have had to if the quotas had not existed.[3] The corresponding additional cost for Canadian consumers in 1969 was about Can.$400-500 million.

Stage 2: Holding Down Domestic Oil Prices, 1973-early 1980s

World oil market conditions changed drastically in the early 1970s. The meeting of the Organization of Petroleum Exporting Countries (OPEC) in 1971 resulted in new arrangements with the international oil companies regarding increased prices and royalties. In October 1973, the Arab oil embargo sent OPEC prices spiraling and initiated the first oil crisis.

U.S. Energy Policy under Nixon, Ford, and Carter

In the United States by 1973, the Nixon administration had already placed crude oil and petroleum products under price controls as part of its efforts to control inflation. It had established a two-tier price system, with the price for "old oil" discovered prior to 1972 set at U.S.$4.25 per barrel while "new oil" was exempt from controls. Then, in December 1973, after imported oil prices had risen to about $8-9 per barrel, President Nixon announced a $1 per barrel increase for "old oil" and introduced legislation for a windfall profits tax. The U.S. Congress also approved construction of an oil pipeline to transport oil from Alaska's North Slope, but not before it had passed legislation prohibiting exports of Alaskan oil.

In 1974, the Ford administration proposed full decontrol of prices of crude oil and newly discovered natural gas. The proposal was abandoned, however, when it met with strong opposition from Congress and the general public, neither of which was convinced that the energy crisis was anything more than shortages contrived by the big oil companies.

The Carter administration made energy a top national priority, but its policies eventually led to a great sense of frustration. In its National Energy Plan of April 1977, it took no action to decontrol energy prices, instead preferring mandatory regulations and voluntary guidelines for energy conservation and the increased use of coal and development of nonconventional energy.

Although President Carter made a commitment at the Bonn Summit in 1978 to raise U.S. crude oil prices to world levels by 1980, it was not until the Iranian revolution in early 1979 had sent world oil prices above U.S.$20 per barrel that he took action. In April 1979, he proposed a phased decontrol of U.S. oil prices, to be completed around the end of 1981 and to be accompanied by a windfall profits tax of 50 percent on producer revenues. By the end of 1979, however, the world price had soared to $30 per barrel, almost double the average wellhead price of U.S.-produced crude oil. Thus, from 1973 through 1980, the United States systematically held domestic energy prices below world levels.

The Trudeau Government's Energy Policies, 1973-80

By the time the first oil shock hit, in October 1973, Canada had already moved to control prices. In March 1973, the Trudeau government, fearing domestic oil shortages, had begun to restrict oil exports to the United States. In September 1973, it followed the U.S. lead by freezing domestic oil prices for six months; it also imposed an oil export tax in order to gain the full world price for its oil exports. After holding Canadian oil prices above world levels for 12 years, Canada had an opportunity in 1973 to abandon the interventionist approach of the National Oil Policy. Instead of setting an independent energy policy for Canada, however, the Trudeau government imitated the U.S. approach.

Canada was somewhat more able to reduce its dependence on OPEC oil imports than was the United States. To do so, however, it had to place further restrictions on Canadian oil exports to the United States. In 1975, the Trudeau gov-

ernment announced that it would phase out such exports completely over a five-year period.

GATT rules permit restrictions on exports in order to conserve a finite resource or to cope with a temporary shortage situation only if exports are cut back in the same proportion as domestic consumption. Canada clearly violated this GATT provision, since it imposed no restrictions on domestic consumption. The United States did not complain, however, for at least three reasons.

First, throughout the 1960s and early 1970s, the United States itself had restricted oil imports under the guise of concerns about national security. Even though Canada had been granted an "overland exemption", the United States had still pressured Canada to limit exports. For the United States to have turned around and launched a GATT action against Canada for restricting exports after it had restricted access to its own market for more than a decade would have been highly unlikely.

Second, the United States had already joined with Canada and other members of the International Energy Agency (IEA) in adopting a policy of limiting its dependence on oil imports. Indeed, in congressional hearings on Canada's restrictions of oil exports in 1976, committee chairman Hubert Humphrey and most witnesses said they did not disagree with Canada's objectives.[4]

Finally, the United States did not need to consider a GATT action since Canada had agreed to bilateral negotiations aimed at ensuring that oil supplies to Northern Tier states were not disrupted unduly by Canada's decision.

Thus, it is fair to say that GATT rules relating to energy trade were ineffectual during the 1960s and 1970s. Government regulation and control of energy production, trade, and pricing was so encompassing that the adoption of such policies implied the suspension of GATT rules on energy trade.

The cost of holding energy prices below world levels in the 1970s was large, as it was when they were held above world levels in the 1960s. U.S. economist Kenneth Arrow estimated that, in the United States, underpricing of oil imposed an efficiency cost of U.S.$3.5 billion on the U.S. economy in 1979, when the gap between world and domestic oil prices averaged $9 per barrel.[5] When the Iranian revolution led to a sudden doubling of the world price, the efficiency cost soared.

Canada, too, suffered a large efficiency cost from the Trudeau government's control of oil prices. Indeed, the cost was larger than in the United States -- after the second oil shock in 1979, Canada allowed the gap between domestic and world prices to widen, rather than decontrolling prices as did the United States. Canada thus maintained the lowest price for crude oil of any industrial country, thereby failing to use the price mechanism to reduce consumption and increase exploration and development to efficient levels.

Stage 3: Deregulating Energy, 1981-Present

After the 1980 presidential elections, U.S. energy policy took yet another turn. One of the first acts of the new Reagan administration was to legislate immediate decontrol of domestic oil prices and a phased move toward complete decontrol of natural gas prices. At the same time, it disbanded much of the Carter administration's institutional mechanisms for controlling energy policy. It also reduced government funding of energy projects and removed or reduced energy-related regulations. A windfall profits tax accompanied decontrol of U.S. energy prices, and in the initial postcontrol period much of the additional revenue from energy sales flowed to the U.S. government.

Along with the 1981-82 recession, this increased reliance on market forces sharply reduced U.S. oil imports and spurred energy conservation in industry. At the same time, the shift to market-oriented energy policies was accompanied by greater security of supply. In the mid-1970s, 75 to 80 percent of U.S. oil imports came from OPEC. By mid-1982, this proportion had declined to 41 percent.[6] In addition, the United States Strategic Petroleum Reserve continued to increase as prices weakened, thereby providing a significant buffer against unexpected disruptions in foreign supplies.

From the NEP
to the Western Accord

Just one week before Ronald Reagan's election, the Trudeau government introduced the National Energy Program (NEP) -- the high-water mark of government intervention in Canadian energy markets. Rather than decontrolling energy prices, as the United States was soon to do and as the IEA was urging all member countries to do, the NEP legislated "made-in-Canada" petroleum prices. As earlier Trudeau energy policies had done, the NEP made lower Canadian prices possible by government regulatory control of domestically produced oil and natural gas prices, a tax on exports, and controls on the volume of exports. It also subsidized the cost of oil imports to refineries in Eastern Canada in order to maintain a single, "made-in-Canada" price for oil across the country.

The NEP began to unravel almost immediately. The producing provinces objected that it infringed on their constitutional control over natural resources. After a lengthy battle, the federal and Alberta governments reached an energy pricing and taxation agreement in September 1981 that continued the "made-in-Canada" pricing policy. Before the ink was dry, however, world oil prices began to fall, and the agreement's provision that Canadian crude oil prices could not exceed 75 percent of the world price was no longer tenable. It was amended in 1982 and 1983 to permit more domestic oil to receive the world price.

The NEP was the major episode in the past 30 years in which Canadian energy policy did not follow the lead of the United States. Indeed, Canada's petroleum pricing policy was diametrically opposed not only to that of the United States but also to those of the other major industrial countries. And although many Canadians supported the NEP, both as a statement of national independence and as a vote for cheap energy, it proved incapable of achieving its objective of insulating Canada from developments in world energy markets.[7]

By the time the federal elections took place in 1984, the process of deregulation of Canadian energy markets was already under way. The new Progressive Conservative government made the dismantling of the remaining features of the NEP a high priority. In March 1985, it reached an agreement with the producing provinces -- the Western Accord -- tc decontrol oil prices immediately and to work toward decontrol of natural gas prices. In the process, it lifted both the export tax and restrictions on exports of crude oil. In the end, then, Canada followed the lead taken by the United States in 1981.

Since 1985, Canadian energy markets have been subject to world market forces to an increasing degree. Price deregulation initially brought increased profits to the petroleum industry. When world oil prices collapsed in early 1986, however, the beneficiaries of the return to market-oriented pricing policies were the consumers.

Lessons from History

From the foregoing discussion of U.S. and Canadian energy policy history, one can make the following observations:

- From the mid-1950s until 1980, Canada opted for energy policies that followed the lead taken by the United States.

These policies involved heavy government intervention, first to hold domestic energy prices above world levels and then to hold them below. Both countries ignored GATT rules and imposed significant restrictions on energy trade to achieve their policy objectives.

- Both countries incurred large efficiency costs by preventing market forces from bringing supply and demand into balance.
- On the one occasion when Canada adopted a significantly different energy policy from the United States -- the period of the NEP -- the Canadian policy proved politically divisive, economically wasteful, and ultimately unsustainable. This does not imply that Canada should always imitate U.S. energy policies, but it does suggest that Canadian energy policies must take account of the two countries' energy interdependence.
- With the return of market-oriented energy policies in the 1980s, both countries can now observe their obligations -- previously ignored in bilateral energy trade -- and enforce their rights under the GATT. Indeed, the energy chapter of the Canada-U.S. Free Trade Agreement affirms that they intend to do so.

Past policies of trade restrictions, price controls, and discriminatory treatment of foreign supplies have proven wasteful, particularly in the 1970s when they encouraged overconsumption and inefficiency. It was, therefore, in the interests of both countries to agree not to adopt such policy options in the Canada-U.S. free trade deal. It does not mean, however, that the two countries have given up the ability to conduct constructive, independent energy policies. To demonstrate that this is the case, it is necessary to examine carefully the exact provisions of the Agreement's energy chapter.

The Energy Chapter

As do most parts of the Agreement, Chapter 9, Energy, with its 9 Articles and 2 Annexes, closely parallels GATT rules.

Article 901 indicates the coverage of energy products as defined under the "Harmonized System" by which imports are classified. The only new wrinkle is that electricity, which is considered an "intangible" and therefore not covered by GATT rules, is clearly included in the Agreement. Since U.S. coal interests have been threatening protectionist actions against Canadian electricity, its inclusion is a clear benefit to Canada.

Article 902 reaffirms both countries' GATT rights and obligations with respect to energy trade restrictions. This is important both because it underscores that these commitments are not new and because it clearly prohibits most restrictions on energy trade, including minimum export or import price regulations, with a few important existing GATT exceptions permitted. Restrictions on exports will be allowed in circumstances relating to temporary supply disruptions, conservation of an exhaustible resource, national security, or the imposition of price controls, but these are subject to certain limitations (as spelled out in Articles 904 and 907). Article 902 also reaffirms each country's ability to determine its own policies toward energy exports to, or imports from, third countries.

In Article 903, both countries agree not to impose any type of export tax or duty on energy unless the same tax is applied on domestically consumed energy. Imposing an export tax -- the most straightforward method of discriminating against foreign purchasers -- is inconsistent with free trade.

Article 904 reaffirms both countries' right to restrict exports for the reasons stated in Article 902, as long as the country imposing the restriction does not reduce the share of the total supply of the energy good that is exported to the other partner, as required under GATT Article XX. This is the "proportional access" that some initially saw as an Achilles heel of the Agreement. On closer examination, however, this is a sharing principle to which Canada, along with 101

other countries, are already committed under the GATT.

What are the implications of proportional access? As long as markets continue to function freely so that supply and demand remain relatively balanced, the rule has no effect. This is because it is only applied if the exporting country (in most cases, Canada) decides it wants to impose export controls. The National Energy Board could decide, for example, that because reserves of crude oil were diminishing, production should be restricted. Canada could then restrict exports to the United States, but only in the same proportion that it restricted total production. The exact amount would be equal to the average proportion of Canadian crude oil that the United States had purchased over the previous 36 months. This specific formula actually clarifies and tightens up the meaning of proportional access, which is relatively vague under GATT rules.

Proportional access is not threatening when one understands (1) that it is Canada that will determine if and when such sharing will be invoked; (2) that Canada is under no obligation to sell any particular quantity to the United States as long as it provides U.S. buyers with access to the required proportion of Canadian supply at commercial terms; and (3) that Canadians can continue to compete commercially to buy any amount of Canadian energy supply up to the total amount.

Some critics of the Agreement have argued that the United States could purchase an increased share of Canadian energy once the Agreement is in place in order to "lock in" a relatively high proportional share in the event of future export controls by Canada. This scenario is highly implausible. It assumes a form of strategic behavior on the part of U.S. energy users that does not exist. North American energy markets are highly competitive, with buyers seeking secure energy supplies at the lowest cost and with U.S. and Canadian producers aggressively competing for market shares. In this environment, there is no incentive for U.S. energy buyers to pay more, as they would have to do, in order to increase their proportional share of Canadian energy. And in the event of a change in the environment to one of energy scarcity, Canada would be in a position to block strategically driven U.S. purchases of Canadian energy by invoking the proportional-sharing arrangement.

Under Article 905, both countries have the right to be formally consulted on any changes in regulatory policies that distort energy trade. The U.S. Federal Energy Regulatory Commission, for example, has recently taken decisions that discriminate against Canadian natural gas. Although these decisions will not be rolled back, in the event of any future regulatory actions Canada could require consultations at the cabinet level -- that is, between energy ministers -- to resolve the dispute. This puts Canada in a stronger negotiating position than it has been in the past.

The value of this provision will only be known once it is tested after the Agreement is implemented. But in the past, U.S. regulatory authorities have amply demonstrated their ability to reduce or delay the access of Canadian energy to U.S. markets. With the prohibition of more overt restrictions on energy trade, it is conceivable that U.S. energy producers will put greater pressure on the regulatory authorities to adopt new regulations that have the effect of discriminating against Canadian suppliers. Thus, Article 905 improves Canada's negotiating position at a time when regulatory obstacles to energy trade could increase in importance.

Article 906 recognizes the importance of oil and gas fiscal incentives for maintaining petroleum reserve levels. This does not constitute an exemption from countervailing duties on flagrant subsidies to the petroleum industry, but it does provide both countries with some leeway in encouraging exploration and development.

Article 907 defines national security more precisely for the purposes of the Agreement than it is under the GATT. This is a benefit to Canada, since, in the case of energy, national security is often the battle cry of U.S. energy producers when they face competitive imports. Under the tighter definition, the United States would only be able to invoke national security to restrict Canadian imports if it was involved in an armed military conflict.

Article 908 says that the Agreement is not inconsistent with the IEA and that IEA commitments supersede those contained in the Agreement. This is an important assurance to other IEA members that Canada and the United States will live up to their international commitments on energy -- including the oil-sharing arrangement under the IEA, which is considerably more onerous than the proportional-sharing arrangement in the Canada-U.S. Agreement. Under IEA commitments, in the event of an oil shortage in the industrial countries, Canada could be required to export increased volumes of oil to other IEA member countries that have no indigenous supplies. This could be a far greater burden to Canada than its commitment in the bilateral Agreement not to reduce its exports to the United States more than proportionately.

Article 909 defines some of the energy chapter's key words and phrases.

The chapter also contains important annexes that:

- exempt Canada from the prohibition on exports of Alaskan oil, up to 50,000 barrels per day;
- eliminate U.S. restrictions on enrichment of Canadian uranium;
- exempt the United States from Canada's requirement that Canadian uranium be upgraded before it is exported;
- permit the administration of "surplus tests" on the export of any energy good in a manner consistent with other provisions of the energy chapter; and
- require the U.S. Bonneville Power Administration to afford British Columbia Hydro fair access to its distribution lines.

That is what the Agreement contains. It is straightforward and clear. It does not create a new continental energy policy. Rather, it confirms and strengthens the existing free trade environment that the energy sector enjoys, while reaffirming and clarifying both countries' rights and obligations under GATT and IEA rules.

Benefits of the Agreement for Canada

Just as concerns about free trade in energy have been overstated, its benefits have not been fully understood. The major benefits are likely to be gained in the longer term, after 2000.

The short-term benefits are small, because something close to free trade in energy has existed between Canada and the United States since 1985, when the Canadian government dropped the complex system of regulated oil and natural gas prices introduced as part of the NEP. There are now no tariffs on the main energy products, with the exception of small U.S. tariffs on crude oil and petroleum products.

There is an important difference, however, between a temporary period of free trade, as has existed for the past three years, and a bilateral treaty that locks free trade in energy into a larger, more permanent agreement. With a treaty that provides stability and confidence that free trade in energy will last, investors can make decisions based on the knowledge that the rules are unlikely to change significantly. They will also know that large, high-cost projects, which only make economic sense if a large market exists, are now more viable. In the 1970s, Canadian taxpayers spent billions of dollars bankrolling Petro-Canada and other companies to look for energy in the Arctic and Atlantic frontiers, only to learn that the cost of producing and transporting such energy would be economically viable only if the volume of en-

ergy produced was extremely large. Under these circumstances, the value of a large, secure market to underwrite the cost and risk should be readily apparent.

Confidence in stable energy policy and the availability of a large, secure market should mean increased activity in the Canadian energy sector over the longer term. What about individual sectors?

Uranium

Canada's uranium industry is a winner under free trade. Canada is the world's largest exporter of uranium, and mines in northern Saskatchewan contain high-grade ore and are highly competitive internationally. The U.S. industry, on the other hand, with its lower-grade, relatively high-cost ore bodies, is in decline. Under these circumstances, U.S. uranium producers have used political action and legal proceedings to try to prevent imports of foreign uranium for enrichment in the United States. A case currently before the U.S. Supreme Court could result in a total embargo on all imported uranium, $400 million of which comes from Canada. The Agreement, however, exempts Canadian uranium from any import restrictions. In the short term, an important market will be maintained; in the longer term, the development potential for the Canadian uranium industry will be greatly expanded.

Crude Oil and Natural Gas

For Canada's oil and gas industry, the most important benefit of free trade is the protection it provides against the kind of damaging, interventionist energy policies that Canada has adopted in the past. The battles of the 1970s and early 1980s between the federal government and the producing provinces over prices, royalties, taxes, and export restrictions greatly damaged activity and confidence levels in the industry. With the Agreement in place, government intervention to regulate prices will be much less attractive. Export controls, export taxes, and minimum export prices will be ruled out. This means that Canadian governments will not be able to intervene to set export prices above domestic energy prices, as the federal government did after 1973 and in the NEP. Canada's policies during this period ignored GATT rules and strained Canadian-U.S. energy relations until it was eventually recognized that they were economically damaging as well as regionally divisive. Thus, an Agreement that commits Canada not to repeat its past energy policy mistakes must be seen as considerably positive for Canada's oil and gas industry.

There will be some small, immediate economic benefits to the oil industry from the reduction in U.S. crude oil and petroleum product tariffs. More sizable benefits, however, can be expected to accrue in the longer term, although it is difficult to make accurate estimates of how large these might be. The Agreement is unlikely to affect Canada's exports of crude oil to the United States. Under existing policies, Canadian petroleum companies face no significant limits on exports, and so the Agreement does no more than preserve the status quo.

In the case of natural gas exports, the impact of free trade is likely to be significant, for two reasons.

First, exports of natural gas from the Western Sedimentary Basin may increase because U.S. buyers are likely to view Canadian gas as a more secure source of supply; because U.S. protectionist measures against Canadian gas will be more difficult to sustain; and because increased confidence in Canada's natural gas industry is likely to lead to increased export capacity. While estimates vary of the likely impact of free trade on natural gas exports, a study by the Independent Petroleum Association of Canada projects that the Agreement will produce a significant increase in Canada's share of the U.S. natural gas market.[8]

Second, the Agreement, or some similar arrangement, is essential for the development of Canada's Arctic and Atlantic

frontier natural gas resources. As a recent Imperial Oil assessment points out, the volumes needed to justify natural gas pipelines from frontier regions are too large to be absorbed by Canada's domestic market, and U.S. buyers will not make commitments that will allow these pipelines to be financed unless they have assured access to supplies.[9]

Electricity

Trade in electricity has always been free of tariffs. With the substantial increase in the volume of Canadian exports after the mid-1970s, however, the threat of U.S. protectionism has increased. The inclusion of electricity in the Agreement, therefore, comes at a time when the industry is entering a phase in which its future rate of growth will depend significantly on secure access to the U.S. market.

In 1986, Canada's net exports of electricity to the United States were valued at approximately $1 billion, most of it in the form of short-term or "interruptible" contracts. As Hydro-Québec's recent sale of electricity to New England demonstrates, however, future sales increasingly will be long-term contracts that require new generating capacity. Thus, free trade will enhance the ability of Canadian electrical utilities to meet the terms of their long-term contracts. This will encourage U.S. utilities to consider imports from Canada.

Some critics of the Agreement claim that, in future, Canada will have to sell electricity to the United States at the same price at which it is sold in Canada. This claim arises, however, from a misunderstanding of how electricity is priced. Electricity is sold at a wide range of prices under contracts that have a wide range of terms and conditions. Guaranteed, long-term electricity, such as that now being sold to the United States, carries a higher price than short-term, interruptible electricity.

Under free trade, electricity pricing will continue at commercial levels agreed to by buyers and sellers. Where commercial terms differ, prices for electricity sold in Canada or the United States also will differ. These prices will still be subject to regulatory tests such as those of the National Energy Board, which require that the price be sufficient to recover all costs and that it be no less than the price available to Canadians for equivalent service in the same area.

As with other segments of the energy industry, then, the main benefits of free trade in electricity will arise in the longer term, as U.S. consumers increasingly see Canada as a dependable, competitive supplier.

Free Trade and Energy Policy Independence

Opponents of the Agreement assert that it will greatly reduce Canada's ability to maintain an independent energy policy. In one sense, this is true. Canada has agreed not to take certain mutually harmful actions against the United States -- such as the export taxes and discriminatory prices it adopted in the 1970s. In return, the United States has agreed not to take mutually harmful actions against Canada -- such as the pressure it put on Canada to restrict petroleum exports to the United States in the 1960s, and the more recent regulatory actions to block Canadian imports of uranium, electricity, and natural gas. But ruling out mutually harmful actions does nothing to reduce Canada's ability to adopt beneficial, independent energy policies.

Opponent's claims such as those in the Introduction notwithstanding, Canadian governments and their agencies will retain ample powers to chart an independent energy policy course for Canada in future.

The provinces retain their powers -- spelled out in Section 92A of the Constitution -- over nonrenewable energy resources and electricity.[10] That section grants the provinces the power to make laws relating to the exploration, development, conservation, and management of their reserves of nonrenewable energy, and also to the generation of electricity. This includes laws controlling the rate of production and exports to other parts of Canada, and those on the taxation of nonrenewable energy and electricity. Section 92A does not grant the provinces the right to control exports to other countries, nor does it permit them to discriminate between the pricing or taxation of energy sold within the province and energy sold outside the province.

The Agreement does not impair any of these provincial powers. The provinces will continue to have jurisdiction over taxation of energy resources and electricity. They will continue to set rules for exploration, conservation, and reserves management. They will continue to determine the rate of expansion of electrical generating capacity. Since the provinces do not have the power to regulate exports to other countries or to establish laws that discriminate between buyers on either prices or taxation, the Agreement's restrictions on discriminatory pricing or taxation do not affect provincial powers.

The National Energy Board retains its powers to monitor and license energy exports in the national interest. Although the NEB changed some specific tests prior to the Agreement -- including the replacement of the natural gas surplus test, which limited NEB approval of gas exports unless reserves exceeded 25 years' current consumption, with a more flexible, market-based test -- it has not given up its power to grant export licenses. Furthermore, the Agreement explicitly recognizes Canada's right to administer surplus tests in the export of any energy good. If the NEB finds that additional exports will impair Canada's ability to meet its future energy needs, it can withhold approval of increased export volumes. If the NEB and the producing provinces believe that a future shortfall will be severe, they can introduce measures to restrict both domestic consumption and exports to the United States proportionately.

In the event of a sharp increase in international energy prices, Canadian governments will have the option, as they have had in the past, of holding Canadian prices below world levels. If the United States were to choose to freeze the price

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of "old oil", as it did following the first oil shock in 1973, Canadian governments could decide to do the same, although all of the evidence indicates that this would be a wasteful and costly policy for both countries.

If the United States chose to allow market forces to determine energy prices, Canada could still hold its energy prices below world levels, although it could not impose an export tax as it did in 1973 in order to charge Americans a higher price. It is unlikely, however, that Canada would adopt a made-in-Canada price, since it would be readily apparent that Canada was selling energy in both the United States and Canada at a price below its market value and its replacement cost -- a clearly inefficient use of the energy resource. On the other hand, if the federal government believed that the sharp increase in world prices was temporary, it might opt for a made-in-Canada price as a means of pursuing macroeconomic and interregional stabilization policy. It is possible that the benefits of such a policy -- as a way of cushioning the stagflationary impact of an energy price increase and avoiding a disruptive interregional transfer of income -- might outweigh the cost of temporarily selling the energy below market value. For such an approach to be acceptable in all parts of the country, however, it would have to be symmetrical -- that is, it would have to provide support to energy industries in the event of a temporary sharp energy price decrease.

As the C.D. Howe Institute has argued elsewhere, a better approach to dealing with sharp movements in world energy prices is to develop more flexible and responsible energy taxes.[11] Indeed, the Agreement should be seen not as a threat to Canada's energy policy independence but as an opportunity to devise a more flexible made-in-Canada energy fiscal system -- one that would cushion the impact on energy consumers of sharp price increases and the impact on energy producers of sharp price drops.

Investment Canada retains its powers to review and block foreign takeovers of financially healthy Canadian petroleum companies with assets exceeding $5 million. This means that U.S. companies cannot buy up existing Canadian-owned petroleum reserves and drain them to supply the United States. In cases of foreign takeover bids for financially crippled Canadian petroleum companies, such as the recently approved takeover of Dome Petroleum by Amoco, Investment Canada retains its powers to set certain performance requirements for the acquiring firm. And in the event that Canadian governments decide to privatize Crown energy corporations, they retain the right to limit the sale of shares in such companies to Canadian citizens.

Nothing in the Agreement prevents Canada from adopting legitimate policies to use its energy resources for industrial advantage. True, governments will not have the option of intervening to set higher prices on energy exports than for domestically consumed energy. But they will be able to promote the development of competitively priced energy sources to supply Canadian industry. They retain the ability to use tax incentives or loan guarantees to encourage the private sector to develop new reserves or new technologies that squeeze more energy out of existing reserves. The producing provinces, through their regulatory agencies and Crown-owned utilities, can offer lower energy prices to industries within the province. The industries that benefit from such subsidized energy may be subject to U.S. countervailing duties on the so-called upstream subsidies, but this would be true with or without the Agreement.

The fact that Canada retains the right to subsidize energy sales to Canadian industry does not mean that it should do so. Some people feel that such a policy gives Canada a competitive advantage. In reality, however, it represents nothing more than a sale of Canadian energy (embedded in industrial pro-

ducts) at less than its market value. It reduces Canada's national income and infuriates trading partners who rightly see it as an unfair trade practice.

Conclusion

Because Canada retains its fundamental powers to manage and conserve its energy resources, and because Canada has a long-standing commitment under the GATT to provide proportional access to its energy supplies in periods of temporary supply disruption, it seems clear that there is nothing in the Agreement that reduces the security of Canada's long-term energy supply.

On the contrary, free trade should enhance Canada's energy security, and that of the United States. Canada's vast energy potential -- in the oil sands and in the Arctic and Atlantic frontier areas -- is unlikely to be developed to supply the Canadian market alone. For these megaprojects to be economically viable, very large volumes of production are required. Undeveloped, these frontier reserves contribute nothing to Canada's security.

Canada has been moving toward free trade in energy since 1985. The benefits, in terms of increased efficiency and flexibility and increased sales to the United States, have already begun to show. Yet the free trade that currently exists cannot be seen as secure, particularly given the swings in energy policy that have occurred over the past 35 years. Canada can achieve the full benefits of free trade in energy if they are secured within a long-term framework of the type provided by the Canada-U.S. Free Trade Agreement.

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